In the Supreme Court of the United States

OCTOBER TERM, 1957

No. 265.

ROSE PEDONE,
Executrix of the Estate of Sam Pedone,
and
ROSE PEDONE,
Petitioners,

vs.

THE UNITED STATES OF AMERICA,
Respondent.

CHARLES PEDONE and MARIAN PEDONE,
Petitioners,

vs.

THE UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF CLAIMS

REPLY BRIEF FOR PETITIONERS.

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ARGUMENT.

Petitioners contend that in using the words "expenses" and "deductions" in the Defense Production Act of 1950, as amended, and the regulations thereunder, Congress and the Economic Stabilization Agency were employing words of art which have a carefully defined meaning under the Internal Revenue Code. The Act provides for

the disallowance of the deduction of expenses which are normally deductible under Section 23 of the Internal Revenue Code of 1939, but Congress did not intend to disallow the offset against gross receipts for cost of goods sold. The word "costs" in Section 405(b) of the Act has reference to costs or expenses under any contract made by or on behalf of the United States or for the purpose of laws other than the revenue laws—references which are inapplicable here. See Economic Stabilization Agency Order 15, 17 Fed. Reg. 2994; Wage Stabilization Board Release No. 41, June 13, 1951.

Furthermore, petitioners recognize that Congress intended to control all wages paid by employers covered by the Act. Petitioners' position does not thwart or limit this Congressional intent. Congress employed various means by which to carry out this control. Sections 409 and 706 of the Act provide for injunctive action, treble damage suits, and criminal punishment for any violation of Section 405. These means of enforcement apply to all overpayments of wages, regardless of whether they constitute part of an employer's cost of goods sold; any wage overpayment could be stopped or penalized through the use of any of these sanctions. Section 405(b) merely added an additional sanction applicable only to wage overpayments, and the limitation of such a sanction to wages which are not a part of cost of goods sold obviously does not contradict or defeat the Congressional intent.

The Weather-Seal Manufacturing Co., 16 T. C. 1312 (1951), affd. 199 F. 2d 376 (6th Cir. 1952), is different from the instant cases. *Weather-Seal* involved wages paid to employees who *produced* the storm windows and doors sold by Weather-Seal. In the instant cases, the services of Pedone Lathing & Plastering Company's plasterers were the very goods sold, and the amounts paid to them con-

stitute its cost of goods sold. The Tax Court recognized implicitly in *Weather-Seal* that receipts which in fact represent a return of capital are not taxable as income.

The case of *Harold Binder*, P-H 1953 T. C. Mem. Dec. ¶ 53,183, merely followed the *Weather-Seal* decision without discussion. Since it also involved the production of goods as distinguished from services, it is similarly different from the instant cases. *Gilmore v. U. S.*, 131 Fed. Supp. 581 (D. C. Calif. 1955), also followed *Weather-Seal* without any discussion of the reasons therefor.

The case of *N. A. Woodworth Company v. Kavanaugh*, 102 Fed. Supp. 9 (D. C. Mich.), affd. 202 F. 2d 154 (6th Cir. 1953), does not reject petitioners' argument. The only constitutional argument raised in that case was whether the Wage Stabilization Act of 1942 was unconstitutional as providing for an excessive fine and cruel and unusual punishment contrary to the Eighth Amendment to the Constitution. The basis of unconstitutionality raised by petitioners here was not raised or decided in that case. The cases of *Solon Decorating Company*, P-H 1957 T. C. Mem. Dec. ¶ 57,035, and *Sidney Zehman*, 27 T. C. No. 107 (1957), both involve the identical issue involved here. Both cases were filed by the attorneys representing petitioners here, and the appeals from the decisions of the Tax Court in those cases to the Court of Appeals for the Sixth Circuit have been held in abeyance by stipulation of the parties and order of the Court pending this Court's disposal of the instant cases.

The Government contends (Br. 8-11) that Congress has the power to levy a tax under the Sixteenth Amendment on the gross receipts derived from a business without the apportionment required by Article I, Section 9 of the Constitution, or to put it another way, that Congress has

the power to tax a return of a taxpayer's capital investment to him without apportionment. This contention has been rejected by many cases and by leading writers on federal taxation. See, for example, *Winkler v. United States*, 230 F. 2d 766 (1st Cir. 1956); *Commissioner v. Weisman*, 197 F. 2d 221 (1st Cir. 1952); *Hamilton National Bank v. District of Columbia*, 156 F. 2d 843 (D. C. Cir. 1946); *Lela Sullenger*, 11 T. C. 1076 (1948); *1 Mertens, Law of Federal Income Taxation* Sec. 5.06 (Rev. ed. 1956); *Magill, Taxable Income* 359 (Rev. ed. 1945). This contention was denied also by *all* of the judges of the court below in deciding the instant cases, majority as well as minority. (Pet. 15, 21). If there is any validity to the Government's contention, which runs contrary to such a multitude of decisions and opinion, it should be for this Court to make such a determination.

The adoption of the Sixteenth Amendment overcame the holding of *Pollock v. Farmers' Loan & Trust Company*, 157 U. S. 429, 15 Sup. Ct. 673 (1895), that whether a tax is direct is to be determined by viewing the burden on the property from which the income is derived. The Sixteenth Amendment, however, did not overrule the holding of *Pollock* that a tax on property is a direct tax that must be apportioned. *Brushaber v. Union Pacific Railroad Co.*, 240 U. S. 1, 36 Sup. Ct. 236 (1916). A tax on gross receipts which include the return of capital is not the tax on income authorized by the Sixteenth Amendment, but is, in effect, a tax on property itself. A tax on capital must be apportioned or, under the *Pollock* case, it is unconstitutional.

Furthermore, the Government's contention conflicts with applicable decisions of this Court in *Burnet v. Logan*, 283 U. S. 404, 51 Sup. Ct. 550 (1931); *Merchants' Loan & Trust Company v. Smietanka*, 255 U. S. 509, 41 Sup. Ct. 386 (1921); *Eisner v. Macomber*, 252 U. S. 189, 40 Sup. Ct.

189 (1920); and *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179, 38 Sup. Ct. 467 (1918).

Many lower courts have interpreted the cases of this Court to mean that Congress must allow for a return of capital under the Sixteenth Amendment. Whether all of these lower courts have misinterpreted this Court's decisions, and we think that they have not, involves an important question of federal law which should be settled by this Court—a question involving consequences of obvious importance to both Congress and taxpayers.

There is a further fallacy in the Government's position even if we assume, for the sake of argument, that Congress did intend to disallow the offset of cost of goods sold against gross receipts and that Congress constitutionally may make such disallowance, i.e., may tax gross receipts. Congress also said in Section 405(b) of the Defense Production Act of 1950 that this offset "* * * shall be disregarded * * * for the purposes of *any other law or regulation*" (italics ours). The "other law" involved here is the Internal Revenue Code of 1939, which levies a tax only on income. The plain fact is that *there is no law levying a tax on gross receipts.* Therefore, the argument that Congress may tax gross receipts is inapplicable and irrelevant. The other laws involved here levy a tax on income, not on gross receipts.

The starting point of all income taxation is gross income under Section 22(a). Gross income, however, is not synonymous with gross receipts. Gross income, the Regulations state, means "the total sales less the cost of goods sold." Regs. 118, Sec. 39.22(a)-5. Certainly there is no confusion in the decisions of this Court to the effect that gross income is not synonymous with gross receipts. As stated in *Doyle v. Mitchell Bros. Co.*, 38 Sup. Ct. 467, 469 (1918):

"* * * By the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. Whatever difficulty there may be about a precise and scientific definition of 'income,' it imports, as used here, something entirely distinct from principal or capital either as a subject of taxation or as a measure of the tax; conveying rather the idea of gain or increase arising from corporate activities * * *.

"* * * In order to determine whether there has been gain or loss, and the amount of the gain if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."

See also *1 Mertens, Law of Federal Income Taxation*, Sec. 5.06 at page 171 (Rev. ed. 1956).

In *Commissioner v. Weisman*, 197 F. 2d 221, 224 (1st Cir. 1952), the court was careful to point out that there is no tax on gross receipts:

"The Commissioner argues that the distinction between deductions and cost of goods is lacking in significance, is tenuous and diminishes tax liability unless the distinction is wiped out or disregarded. We disagree with this contention for we believe there is a real distinction between offsets, such as cost of goods under § 22 and deductions under § 23. It is not a difference without substance and has more support for its existence than being merely an historical accident. The return of capital is guaranteed by the 'cost of goods' offset against gross receipts and thus is avoided the charge that it is a tax on capital and not on income * * *. The tax under consideration is not a tax on gross receipts."

Therefore, the Defense Production Act of 1950 does not provide for the disallowance of the offset for cost

of goods sold, since the only law involved here to which its provisions could possibly refer is a law which taxes income but not gross receipts.

CONCLUSION.

The Government argues that Congress may constitutionally disallow the return of capital to a taxpayer and thereby tax his gross receipts. This argument is contrary to court decisions. Furthermore, the argument is irrelevant since the tax laws provide for no tax on gross receipts but only on income. These questions, specifically reserved by this Court in *Allen v. Grand Central Aircraft Company*, 347 U. S. 535, 74 Sup. Ct. 745 (1954), (Pet. 5-6) are ones of basic, fundamental importance and are peculiarly appropriate for the exercise of this Court's discretionary jurisdiction.

For the foregoing reasons and for the reasons set forth in the petition for a writ of certiorari, the petition should be granted.

Respectfully submitted,

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